LEAGUE OF CALIFORNIA CITIES

A Primer on California City Finance

L E A G U E O F C A L I F O R N I A C I T I E S

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A Primer on California City Finance

by Michael Coleman

You've been elected to the city council. You already know that the question of money arises for every local issue. So how does your city pay its bills? While every city is different — each with its own needs, local economy, expectations, protocols, responsibilities and finances — the essential elements of city revenues and spending are the same throughout California.

About This Primer

Western City first published "A Primer on California City Finance" in 2002. The passage of Proposition 1A by California voters in 2004 changed key elements of city financing by enhancing the level of control cities will be able to exercise over their property tax, sales tax and vehicle license fee revenues, and minimizing the possibility of state funding take-aways. This updated primer explains these changes, providing a fresh look at the revenue sources that a city budget comprises and the rules and requirements governing the use of these various funds.

An Overview of City Revenue Sources

City officials may ask: What money does our city get and how is it spent? Revenue, the bread and butter of city budgets, comes from a variety of sources. Some is restricted to certain uses by law. Some revenue is payment for a specific service by customers. Other revenue requires voter approval for rate increases. Still other revenue comes from state and federal agencies, and the city has no control over how much it receives. The California Constitution and state law provide some specific distinctions among municipal revenue sources.

Taxes

A tax is a charge for public services and facilities. There need not be a direct relationship between the services and facilities used by an individual taxpayer and the tax paid. Cities may impose any tax not otherwise prohibited by state law (Gov't. Code section 37100.5). The state prohibits local governments from taxing certain items, including cigarettes, alcohol and personal income; these are taxed by the state for its own purposes.

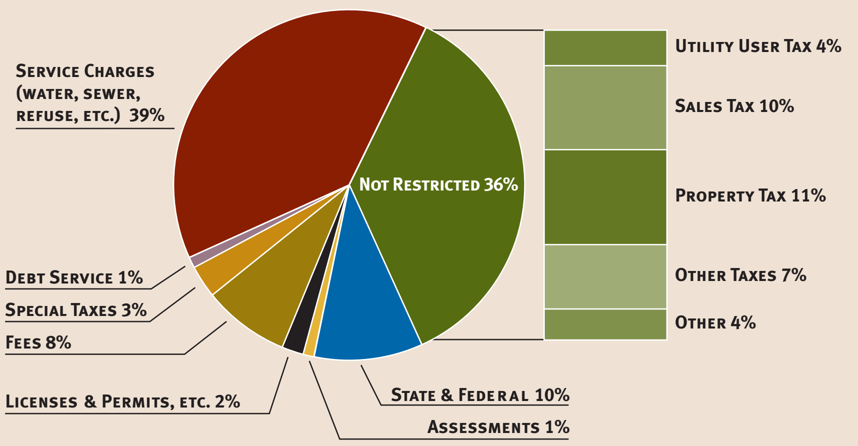
The California Constitution distinguishes between a general tax and a special tax. General tax revenues may be used for any purpose. A majority of voters must approve a new general tax, its increase or extension in the same election in which city council members are elected. Special tax revenues must be used for a specific purpose, and two-thirds of voters must approve a new special tax, its increase or extension.

Fees, Charges and Assessments

A fee is a charge imposed on an individual for a service that the person chooses to receive. A fee may not exceed the estimated reasonable cost of providing the particular service or facility for which

Michael Coleman is principal of Coleman Advisory Services and fiscal consultant to the League. He can be reached at <coleman@cal.net>. More information on city finance is available on Coleman's website at www.californiacityfinance.com.

Typical California City Revenues*



** Based on total cities statewide*

the fee is charged, plus overhead. Examples of city fees include water service, sewer service connection, building permits, recreation classes and development impact fees.

Cities have the general authority to impose fees (charges and rates) under the cities' police powers granted by the state Constitution (Article XI, sections 7 and 9). There are specific procedures in state law for fee and rate adoption. Proposition 218 provides special rules for property-related fees used to fund property-related services.

Special benefit assessments are charges levied to pay for public improvements or services within a predetermined district or area, according to the benefit the parcel receives from the improvement or services. The state Constitution requires property-owner approval to impose a benefit assessment. Other locally raised revenues include licenses and permits; franchises and rents; royalties and concessions, fines, forfeitures and penalties; and investment earnings.

Intergovernmental Revenue

Cities also receive revenue from other government agencies, principally the state and federal governments. These revenues include general or categorical support monies called subventions, as well as grants for specific projects, and reimbursements for the costs of some state mandates. Intergovernmental revenues provide 10 percent of city revenues statewide.

Other City Revenues

Other sources of revenue to cities include rents, concessions and royalties; investment earnings; revenue from the sale of property; proceeds from debt financing; revenues from licenses and permits; and fines and penalties. Each type of revenue has legal limitations on what may be charged and collected as well as how the money may be spent.

Putting Money in Its Proper Place

The law restricts many types of city revenues to certain uses. As explained above, a special tax is levied for a specific program. Some subventions are designated by law for specific activities. Fees are charged for specific services, and fee revenue can fund only those services and related expenses. To comply with these laws and standards, finance departments segregate revenues and expenditures into separate accounts or funds. The three most important types of city funds are special revenue funds, enterprise funds and the general fund.

Special revenue funds are used to account for activities paid for by taxes or other designated revenue sources that have specific limitations on use according to law. For example, the state levies gas taxes and subvenes some of these funds to cities and counties. A local government deposits gas tax revenue in a special fund and spends the money for streets and road-related programs, according to law.

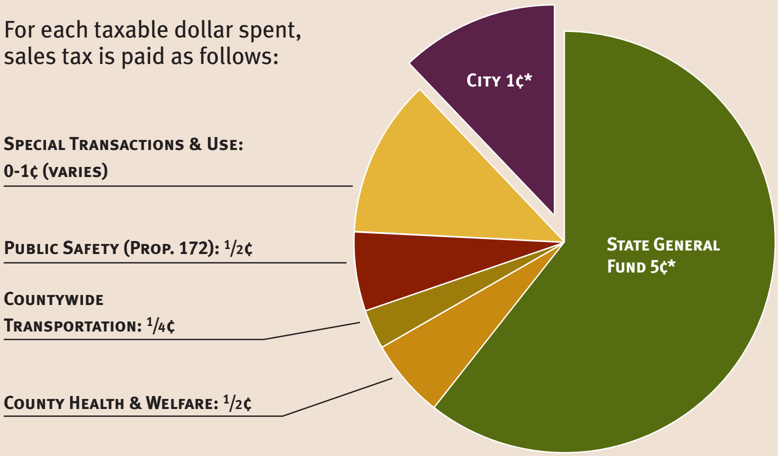
continued

City Responsibilities Differ

Comparing revenues and expenditures of different cities can be difficult because cities vary according to the needs of their constituents and the nature of the local economy, as well as the service and financial responsibilities of the city. Less than 25 percent of California cities are full-service cities, responsible for funding all of the major city general fund-supported services such as police, fire, library, parks and recreation, and planning. In about three out of 10 California communities, a special district provides fire services with property tax revenue that would otherwise go to the city. In six out of 10 cities, library services are provided and funded by another public agency. On the revenue side, these differences in financial responsibility among cities are generally reflected in the allocation of property tax revenue. Other city tax rates and allocations are unrelated to service responsibility.

Sales Tax: How Much Goes to Your City?

For each taxable dollar spent, sales tax is paid as follows:



*Under Prop. 57, beginning in FY 2004–05, the local (city) sales tax rate is reduced by 0.25 percent and the state rate increased by 0.25 percent to repay state fiscal recovery bonds. Cities and counties are reimbursed dollar for dollar with additional property tax. This arrangement, known as the "triple flip," will last about 10 years until the bonds are repaid.

Notes

1. California sales tax revenues are distributed based on the place ("situs") where each sale occurs.
2. Cities receive about 6 percent and counties get 94 percent of Prop. 172 funds. The funds are restricted for public safety services such as police, fire, district attorney and jails.
3. The state sales tax rate is 6.25 percent, including 0.5 percent for county health and welfare programs, 0.5 percent for Prop. 172 and 0.25 percent for the Prop. 57 "triple flip."
4. The city portion of sales tax goes to the county if the sales transaction occurs in an unincorporated area of the county.
5. Many counties and some cities add transaction and use rates ranging from 0.25 percent to 1.25 percent. These additional rates cause the total California sales tax to vary from 7.25 percent to 8.75 percent.
6. Some cities share a portion of their 1-cent rate with their county.

Source: California State Board of Equalization, Coleman Advisory Services

Enterprise funds are used to account for self-supporting activities that provide services on a user-charge basis. For example, many cities provide water treatment and distribution services to their residents. Users of these services pay utility fees, which the city deposits in a water enterprise fund. Expenditures for water services are charged to this fund.

The general fund is used to account for money that is not required legally or by sound financial management to be accounted for in another fund. Major sources of city general fund revenue include sales and use tax, property tax and local taxes, including business license tax, hotel tax and utility user taxes.

Major City Revenues

Sales and Use Tax. The sales tax an individual pays on a purchase is collected by the state Board of Equalization and includes a state sales tax, the locally levied Bradley-Burns sales tax and several other components. The *sales tax* is imposed on the total retail price of any tangible personal property. (State law provides a variety of exemptions to the sales and use tax, including resale, interstate sales, intangibles, food for home consumption, candy, bottled water, natural gas, electricity and water delivered through pipes, prescription medicines, agricultural feeds, seeds, fertilizers and sales to the federal government.) A *use tax* is imposed on the purchaser for transactions in which the sales tax is not collected. Sales and use tax revenue received by cities is general purpose revenue and is deposited into a city's general fund. Although cities vary widely, on average, sales and use tax revenue provides 30 percent of city general purpose revenue and often as much as 45 percent.

Cities and counties may impose additional transaction and use taxes in increments of 0.25 percent with a two-thirds city council approval and majority voter approval. A city may impose more than one transaction and use tax: One might be for a general purpose; a second might be for a special purpose. The combined rate of the city and county transaction and use taxes may not exceed 2 percent.

Property Tax. The property tax is an ad valorem (value-based) tax imposed on real property and tangible personal property. (State law provides a variety of exemptions to the property tax, including most government-owned property; nonprofit, educational, religious, hospital, charitable and cemetery properties; the first $7,000 of an owner-occupied home; business inventories; household furnishings and personal effects; timber; motor vehicles, freight and passenger vessels; and crops and orchards for the first four years). California Constitution Article XIIIA (Prop. 13) limits the property tax to a maximum 1 percent of assessed value, not including voter-approved rates to fund debt. The assessed value of property is capped at 1975–76 base year plus inflation — or 2 percent per year. Property that declines in value may be reassessed at the lower market value. Property is reassessed to current full value upon change in ownership (with certain exemptions). Property tax revenue is collected by counties and allocated according to state law among cities, counties, school districts and special districts.

The share of property tax revenue allocated to a city varies depending on a variety of factors, including:

- The service responsibilities of the city (for example, if fire services are funded and provided by a fire district, then the district gets a portion that would otherwise go to the city);
- The presence of a redevelopment agency, which retains a portion of revenue growth; and
- The historic (1980) tax rates of the city in relation to other local taxing entities.

City property tax revenues are also affected by local property values.

Business License Tax (BLT). Most cities in California levy a business license tax. Tax rates are determined by each city, which collects the taxes. Business license taxes are most commonly based on gross receipts or levied at a flat rate but are sometimes based on the quantity of goods produced, number of employees, number of vehicles, square footage of the business or some combination of factors. In all cases, cities have adopted their tax as a general tax. On average, the business license tax provides about 3 percent of city general revenue and often as much as 6 percent. For businesses that operate in more than one city, state or county, cities can impose a business license tax on only that portion of the business transacted in that city.

Transient Occupancy Tax (TOT). Like the business license tax, a TOT may be levied by a city under the police powers granted to cities in the state Constitution. More than 380 cities in California impose TOT on people staying for 30 days or less in a hotel, inn or other lodging facility. Rates range from 4 to 15 percent of the lodging cost. In nearly all cases, cities have adopted these as general taxes, but some cities make a point of budgeting the funds for tourism or business development-related programs. Among cities that impose a TOT, it provides 7 percent of a city's general revenues on average and often as much as 17 percent.

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The Effects of Proposition 13

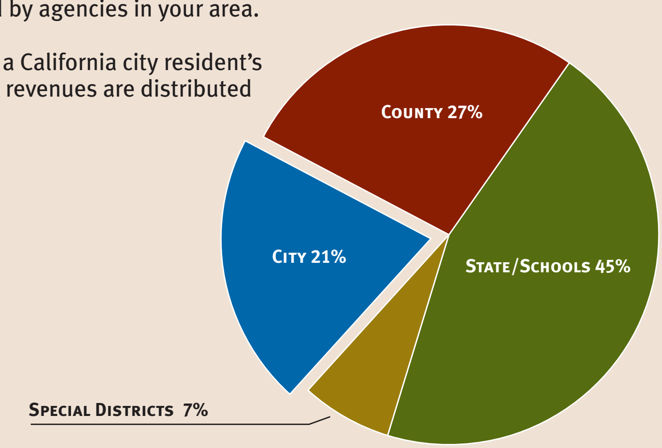
Proposition 13 produced the following results:

- Elderly and low-income homeowners' tax burden was decreased;
- Similarly situated properties are taxed differently;
- Local government property tax revenues were cut by 60 percent;
- Revenue windfalls from personal income tax produce $1 billion for the state and $1.6 billion for the federal government annually;
- Cities and counties raised user fees and local taxes;
- The authority to allocate local property tax shifted to the state (Prop. 1A now limits the state's authority);
- Counties and schools rely more heavily on the state general fund with a corresponding shift in power;
- Cities rely more heavily on other general revenues, including locally imposed taxes and the sales and use tax; and
- Tax rates/shares (from 1980) are now out of sync with service demands.

Property Tax: How Much Goes to Your City?

The allocation of property taxes to government agencies varies among different areas, depending on historic (pre-Prop. 13) property tax levels and which services are provided by agencies in your area.

On average, a California city resident's property tax revenues are distributed as follows:



Notes

1. This is the rate for the average city for properties not in a redevelopment area. Results vary depending on the extent of services provided by your city. Full-service cities may receive slightly more. Cities in which fire services are provided by a special district receive less, with the difference going to the fire district.
2. For properties in the unincorporated area of a county, the county gets a bigger share of the property tax, which would otherwise go to a city. If the area ever incorporates, some of the county share becomes the share for the new city.
3. City and county property tax shares include "property tax in lieu of Vehicle License Fee."
4. This does not include the temporary reimbursement for city sales tax with property tax for sales tax under the Prop. 57 "triple flip."

Source: California State Board of Equalization, Coleman Advisory Services

The Facts About Proposition 1A

In November 2004, California voters approved Prop. 1A, a ballot measure sponsored by the League and a broad coalition that included Governor Arnold Schwarzenegger, legislators, other local governments, and public safety, business and community organizations. This landmark amendment to the state Constitution was intended to restore predictability and stability to local government budgets. The measure:

1. Strengthens prohibitions against unfunded state mandates by requiring the state to suspend state mandates in any year the Legislature does not fully fund those laws;
2. Expands definition of state mandate to include transfer of responsibility of a program for which the state previously had full or partial responsibility; and
3. Prohibits the state from:
   - Reducing the local Bradley-Burns Uniform Sales & Use Tax rate or altering its method of allocation, except to comply with federal law or an interstate compact;
   - Decreasing Vehicle License Fee revenue from the 0.65 percent rate without providing replacement funding to cities and counties; and
   - Shifting property taxes from cities, counties or special districts, with the following exceptions:
     a) The state may reallocate among cities, counties and special districts (but not schools or any other local entity) with a two-thirds vote of both houses of the Legislature.
     b) Beginning in FY 2008–09, the state may borrow up to 8 percent of the property tax revenue within a county (currently about $1.3 billion on a statewide basis) if:
        - The governor declares a “fiscal hardship”;
        - The Legislature enacts an urgency statute by a two-thirds vote;
        - The funds are repaid within three years;
        - The FY 2003–04 VLF backfill gap has been repaid;
        - Any previous borrowing of this kind has been repaid; ***and***
        - The state has not borrowed from the revenues more than twice in 10 years.

Utility User Tax (UUT). More than 150 cities (collectively representing a majority of the state’s population) impose a utility user tax. UUT rates vary from 1 to 11 percent and are levied on the users of various utilities, which may include telephone, electric, gas, water and cable television. For cities that impose the UUT, it provides an average of 15 percent of general revenue and often as much as 22 percent.

Vehicle License Fee (VLF). The VLF is a tax imposed by the state on the ownership of a registered vehicle in place of taxing vehicles as personal property. Under California Constitution Article XI, section 15, VLF revenue (based upon a rate of 0.65 percent) must go to cities and counties. Since 1948, the VLF tax rate had been 2 percent. In 1998, the Legislature and governor began cutting the tax, backfilling the loss to cities and counties with a like amount of state general fund money. In 2004, the state reduced the rate to 0.65 percent and re-placed the state general fund backfill to cities and counties with additional property tax in lieu of VLF (see paragraph below). The VLF is collected by the state Department of Motor Vehicles (DMV). Most VLF revenue goes to fund county health and welfare programs (75 percent) and DMV administrative charges (14 percent). The allocation to cities is on the basis of population and provides about 1 percent of general revenues to the average city budget.

Property Tax in Lieu of Vehicle License Fee. In FY 2004–05, cities and counties began receiving additional property tax to replace VLF revenue that was cut when the state repealed the state general fund backfill for the reduction in the VLF. Beginning in FY 2005–06, this property tax in lieu of VLF grows with the change in gross assessed valuation of taxable property in the jurisdiction from the prior year. Property tax in lieu of VLF allocations are in addition to other property tax apportionments.

Property tax revenue (including property tax in lieu of VLF) accounts for more than one-third of general revenue for the average full-service city. For cities that do not fund fire service, property tax revenue represents on average 25 percent of general revenue.

Parcel Tax. This is a special nonvalue-based tax on property, generally based on either a flat per-parcel rate or a variable rate depending on the size, use or number of units on the parcel. Parcel taxes require two-thirds voter approval and are imposed for a variety of purposes, including police and fire services, parks, libraries and open space protection. Parcel taxes provide less than 1 percent of city revenues statewide.

Rents, Royalties and Concessions. Examples of revenues generated through the use of city property include royalties from natural resources taken from city property, the sale of advertising in city publications, payments from concessionaires operating on city property, facility rentals, entry charges, on- and off-street parking charges and even golf fees.

Franchises. Franchise fees are collected in lieu of rent for use of city streets from refuse collectors, cable television companies and utilities. Some franchise charges are limited by statute.

Fines, Forfeitures and Penalties. Cities receive a share of fines and bail forfeitures from misdemeanors and infractions committed within city boundaries. State law determines the distribution and use of state-imposed fines and forfeitures, but cities determine penalties for violations of their municipal codes.

Service Charges and Fees. Cities have authority to impose fees, charges and rates for services and facilities they provide, such as plan checking or recreation classes. Use of these revenues is limited to paying for the service for which the fees are collected, but may include overhead, capital improvements and debt service.

City utilities and enterprises supported by service fees constitute a substantial portion of most city budgets. These include water, sewer, electricity and solid waste services. In some cities, a public or private agency other than the city provides and funds these services.

Most Discretionary Dollars Go to Public Safety

In most cities, roughly two-thirds of the total city budget is either earmarked for specific purposes (such as special taxes, restricted state grants and debt obligations like bonds) or is fee revenue used to pay for services provided. In the typical full-service city, three out of five of these discretionary dollars are spent on police and fire services.

… And There's More

City budgets can be bewildering. Myriad laws and limitations make city funding a very complicated subject. Understanding the essentials of city finance is critical for any city decision-maker. Elected officials find their job is made easier when they are able to explain the basic elements of municipal finance to their constituents.

Trends in California City Finance

The following list summarizes trends in California city finance.

- State and federal aid to California cities is declining, down from 21 percent of a city's budget in 1974–75 to 10 percent today.
- The sales tax base is declining, due to a shift toward a service-oriented economy and increasing Internet and catalog retail sales.
- Limitations on taxes and fees that cities can impose are driven by Prop. 13, Prop. 218 and other state laws.
- State population growth is higher in cities.
- Cities must respond to citizens' demand for a greater array of services that bring with them additional costs and new challenges (high tech, cable, transit, etc.).
- Public safety spending is up.
- Infrastructure improvements and maintenance are lagging.

For More Information

More information about city finance is available from these online sources:

- *California Local Government Finance Almanac*, www.californiacityfinance.com
- *Primer on California's Tax System*, Legislative Analyst's Office, www.lao.ca.gov
- *The Fiscal Condition of California Cities*, Institute for Local Government, www.ilsg.org

In addition, the following publications are available from CityBooks. To order, call (916) 658-8257 or visit www.cacities.org/store.

- *Municipal Revenue Sources Handbook*, League of California Cities. $25; Item No. 1031
- *Local Government Dollars & Sense by* Len Wood. $30; Item No. 105

After Proposition 1A:
What's Next for California City Finance?

California city officials and their partners in the LOCAL ("Leave Our Community Assets Local") coalition should feel very proud of what they have accomplished in the past few years. Surprising many political pundits, they succeeded in building the grassroots organization and raising the funds needed to qualify a constitutional amendment for the statewide ballot. Then they ran a successful statewide campaign that resulted in passage of Proposition 1A by almost 84 percent — a truly remarkable achievement. As explained in this primer, the passage of Prop. 1A will end the practice of state take-aways of local funds needed to pay for local services.

But even as local officials give themselves a well-deserved pat on the back, now is not the time for complacency. If city officials have learned anything during the past 15 years, it's that they need to be constantly vigilant about state actions that can impact local decision-making. Sometimes proposed legislation is the source of concern. But impacts can also occur as a result of new ballot measures attempting to amend or contradict constitutional provisions that currently protect local funds.

What can local officials do? What can anyone do, if they care about local democracy?

A lot — much remains to be done. The League of California Cities is working hard to ensure that we maintain and build upon the activities that made Prop. 1A possible. All these activities depend upon the active involvement of League members, as well as labor, business and community groups who care about protecting local services.

How You Can Help Protect Local Services

- **Become an advocate.** Your participation is critical as fiscal issues are debated in the state Capitol or when measures that could undermine local decision-making are placed on the statewide ballot.
- **Help to educate your legislators** on how your city would be impacted by legislative proposals. Contact your League regional representative to volunteer for this and other efforts. Find your regional rep's contact info online at www.cacities.org/regionalrepresentative.
- **Sign up for electronic League Action Alerts** that you receive whenever there's a pressing need for your legislator to hear directly from you. Visit the League's online Advocacy Center (www.cacities.org/advocacy) to receive alerts that include sample letters you can write and send online, or talking points to use when you call your legislators. It's fast, it's easy — and it's effective!
- **Contribute to CITIPAC**, the League's political action committee. The League needs non-public funds to engage in ballot measure advocacy. Your dollars help make that possible. Learn how you can help by visiting www.citipac.org.

Learn More. Stay abreast of proposals that would impact local services.

- Make regular visits to the League's website (www.cacities.org). You'll find information on issues affecting California cities and resources to help understand the issues. You can also find out how to get involved with League advocacy activities.
- Subscribe to *Priority Focus*, the League's weekly online newspaper (www.cacities.org/priorityfocus) and *Western City*, the League's award-winning monthly magazine (www.westerncity.com).
- If you're a city official, sign up for a League listserv. You'll be better connected with your colleagues in other cities and receive (www.cacities.org/listserv).